



Internal Capital Adequacy Assessment Process (ICAAP) Design & Structure

Rabih Nehme

August 2014

Beirut, Lebanon

Outlines

I. Basel III & the ICAAP

II. The ICAAP Design

III. The ICAAP Methodology

Basel II – Pillar II – Supervisory Review Process

Bank's responsibilities for capital assessment

Principle 1 Bank's responsibilities to have a comprehensive process in place to assess the adequacy of **capital** levels based on their **risk profile**

Supervisor's Review Process

Principle 2 Responsibilities of supervisors for assessing a bank's capital adequacy process

Principle 3 Importance of banks operating above the minimum capital ratios

Principle 4 supervisory review to be proactive in resolving transparency & disclosure & cross-border communication & cooperation

Do we really need to implement Pillar 2?

- Banks don't have same Risk profiles
- Basel 1 / Basel 2 & the issue of *Risk sensitivity*
- Pillar1 loopholes:
 - *SA: Blind reliance on rating agencies' risk assessments*
 - *AA: Statistically based risk models underestimated the real risk volume*
- Pillar 2 differentiate between banks risk profiles:
 - Enhancing Internal Governance & Risk Management Practices

Basel III

- Paragh 11:
 - The Pillar 1 & Pillar 3 Enhancements to Basel II must be implemented by the *end of 2011*
 - The new package will be implemented fully by *end of 2019*
 - *The Pillar 2 standards became effective when they were introduced in July 2009.*

Enhancements to Basel 2 (Pillar2): Reassurance on ICAAP

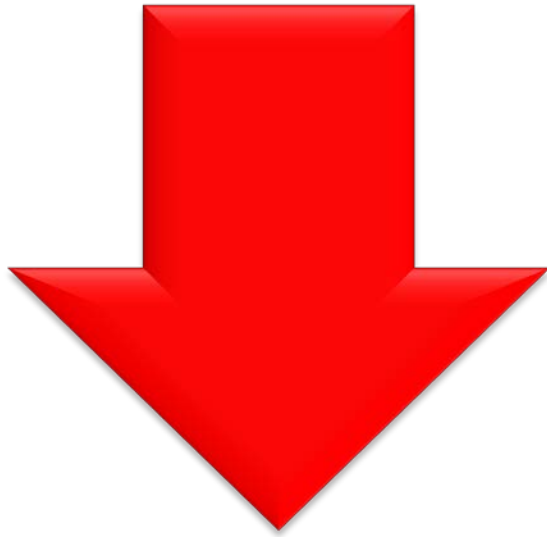
- A thorough and comprehensive (ICAAP) is a vital component of a strong risk management programme.
- The ICAAP should produce a level of capital adequate to support the nature and level of the bank's risk.
- *Supervisors have to evaluate the sufficiency of the bank's internal assessment and to intervene where appropriate.*

Interaction of the buffers with Pillar 1 and Pillar 2

- The countercyclical capital buffer incorporates elements of both Pillar 1 and 2.
- It is like a Pillar 1 approach in that it is a framework consisting of a set of mandatory rules and disclosure requirements.
- However, its use of jurisdictional judgement in setting buffer levels and the discretion provided in terms of how authorities explain buffer actions are more akin to a Pillar 2 approach.

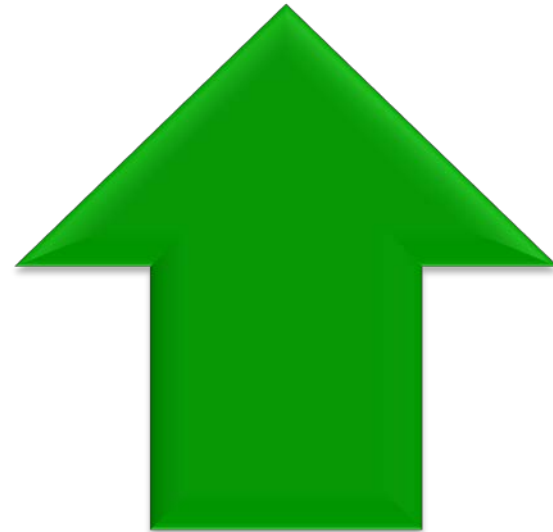
Interaction of the buffers with Pillar 1 and Pillar 2

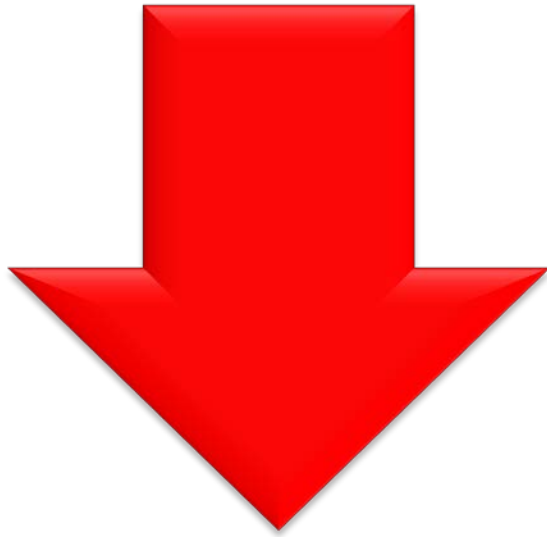
- Authorities have to ensure that a bank's Pillar 2 requirements do not require capital to be held twice for financial system-wide issues, if they are already captured by the countercyclical buffer when the latter is above zero.
- Pillar 2 will capture additional risks that are not related to system-wide issues (eg concentration risk), capital meeting the countercyclical buffer should not be permitted to be simultaneously used to meet these non-system-wide elements of any Pillar 2 requirement.



Capital

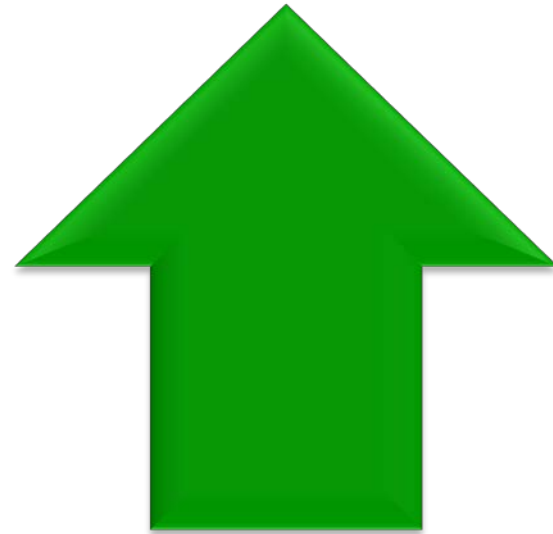
Risk

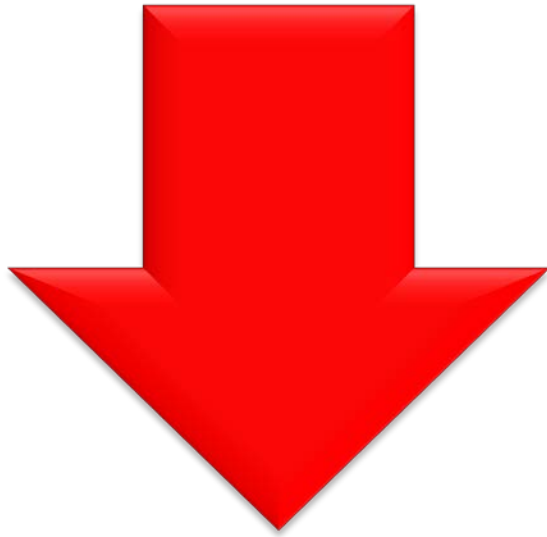




*Internal
Governance*

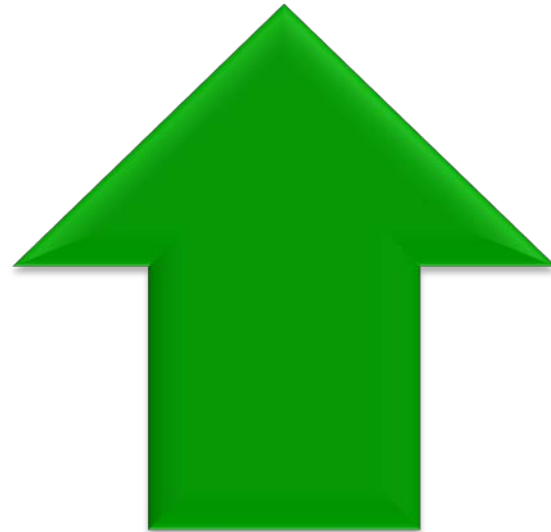
Risk

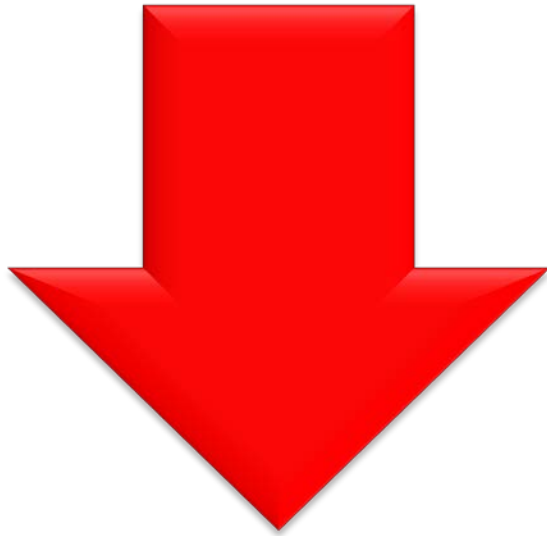




Control

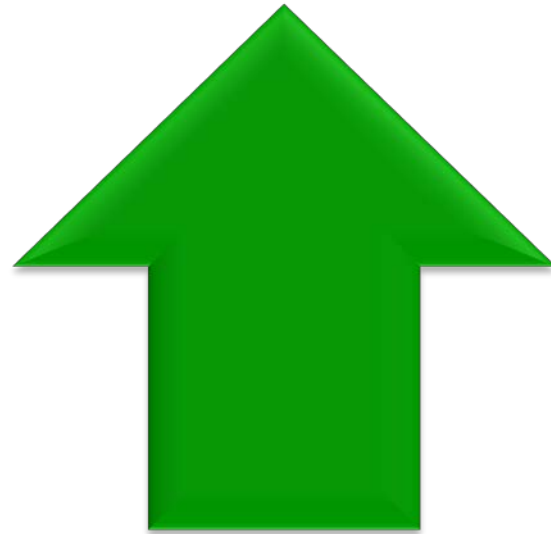
Risk





***Risk
Management***

Risk



- Capital should **not** be regarded as **a substitute** for addressing fundamentally inadequate control, Governance or risk management processes.

Outlines

I. Basel III & the ICAAP

II. The ICAAP Design

III. The ICAAP Methodology

Governance of the ICAAP



Proportionality

- specific design is determined according to this principle
- Banks are required to apply the ICAAP regardless of their size and complexity
- No generally accepted definition of proportionality
- This will primarily depend on the nature and scale of the banks business activities

- *Key Points: Risk level and complexity*



Proportionality: Factors TBT

- Size
- Significance to financial stability
- Risk profile, Business model
- Complexity
- Sophistication
- History of compliance
- Legal status of the bank

Proportionality:

basic questions

- Which types of Risks are **more** significant?
- Which type of Risks are less significant?
 - Answers are based on the bank specific **Risk structure:**
 - **Risk Indicators for specifying Risk Structure**

ICAAP

1. The appropriate identification and measurement of risks;
2. an appropriate level of internal capital in relation to the banks risk profile;
3. The application and further development of suitable risk management systems

Outlines

I. Basel III & the ICAAP

II. The ICAAP Design

III. The ICAAP Methodology

Elements of a Risk-assessment Framework

- A Risk Assessment Framework (RAF) involves the following elements:
 - Identifying significant operations, such as business lines, products & processes
 - Risk identification and assessment for significant operations
 - Risk management, controls and mitigants
 - Net risk
 - Overall assessment

Identifying Significant Operations

- Criteria that may be used to determine the significance of a bank's business lines:
 - *Assets* relating to the activity or the entity in relation to total assets (consolidated, on- and off-balance sheet)
 - *Risk-weighted assets* generated by the activity or the entity in relation to total risk-weighted assets
 - *Revenue* generated by the activity or entity in relation to total revenue

Identifying Significant Operations

- Criteria that may be used to determine the significance of a bank's business lines:
 - *Net income* for the activity in relation to total net income
 - *Regulatory capital* required for the activity in relation to total regulatory capital required

Identifying Significant Operations: *sources*

- Significant operations can be identified from various sources, such as:
 - Internal and external financial reporting,
 - Organization charts and
 - Strategic business plans.

II- Inherent Risk

(building blocks) should be analyzed using data gathered from:

statistical returns,

on-site visits and

a range of other sources.

Inherent Risk

- The 'building blocks' are:

1. Credit & Counterparty risk
2. Market risk
3. Operational risk
4. Liquidity risk
5. Concentration Risk
6. Interest Rate Risk
7. Other risks



*This is
not a list
of
Banking
Risks*

Risk Indicators

- Management is responsible for assessing risk indicators.
- Management should also be able to justify this assessment vis-à-vis the *supervisor*

Indicators for Specifying Risk Structure

- Risk indicators are provided as suggestions
- Self-assessment using simple methods
- The more significant a risk is considered, the better the banks risk management procedures should be

Credit Risk Indicators

- Structure of the banks *credit portfolio* provides initial indications of its risk appetite.
 - A large share of loans in a certain asset class (e.g. exposures to corporates) may point to increased risk.
 - The presence of complex financing transactions such as specialized lending:
 - Project Finance, object and commodities finance ...
- For a rough initial assessment you can use:

Standardized Approach of Basel 2 to examine the distribution of the credit portfolio

Credit Risk Indicators

- Poor creditworthiness in the loan portfolio
- The amount of available collateral
- The unsecured volume
- The type and quality of collateral:
 - To what extent is the retention or liquidation of the collateral legally enforceable?
 - How will the value of the collateral develop?

Credit Risk Indicators

- The distribution of exposures among industries:
 - Construction business,
 - Transport,
 - Tourism,
- Operations abroad:
 - Share of foreign assets
 - Country risk
 - Transfer risk

Equity Risk Indicators (Participations)

- The share of equity investments in total assets
- The required capital for these investments
- The equity investments to be deducted from own funds under the Pillar 1 Calculation
- The country of the investee institutions
- The industry and business areas in which the investee institutions operate

Market Risks indicators

- The size and types of the trading portfolio
- The resulting capital requirements
- The organization and design of trading operations.
 - Significant powers for traders (own limits, risk capital)
 - Their Remuneration are based on trading performance?

Liquidity Risk Indicators

- Comparing liquid or easily liquidated balance-sheet assets with short-term liabilities
- Residual maturity statistics
 - If, for example, short-term liabilities approach the level of liquid or easily liquidated balance-sheet assets, this can point to a higher level of liquidity risk.
- Liquidity for other entities of the Group

Operational Risk Indicators

- The size of the bank
- The complexity of its operations
 - Number of employees,
 - Business partners,
 - Customers,
 - Branches,
 - Systems and
 - Processes

Operational Risk Indicators

- staff fluctuation rate,
- days of sickness leave,
- hours of overtime,
- number and duration of system failures,
- internal audit findings,
- frequency of complaints,
- wrong account entries.

Risk Management, Controls and Mitigants

- The third step in a **RAF** is to assess the bank's risk management and control processes.
- This involves examining:
 - The bank's management structure,
 - Policies and procedures,
 - Systems and controls,
- and then:
 - *assessing how individual risks are managed, controlled and mitigated.*

Controls responsibility

- These controls are the responsibility of the Board and/or senior management and deal with:
 - **Organisational structure,**
 - **Accounting policies and processes,**
 - **Checks and balances, and**
 - **The safeguarding of assets & investments**

Net Risk

- *Net risk = Inherent risk offset by the aggregate quality of risk management.*
- **EX: retail lending** : It may be evaluated as having a high aggregate level of inherent risk.
- Net risk may be rated as moderate due to mitigation by strong risk management/controls (for instance, strong internal audit, risk management, and senior management and board of directors oversight).

Overall Assessment

- Once the assessment of inherent risks, the quality of risk management, and the resulting net risk evaluation for each significant activity is complete, an 'overall' or 'composite' assessment can be determined for the bank.
- In arriving at the overall assessment, several factors are taken into account. EX: Relative materiality of each activity.

Overall Assessment

- An activity's materiality may be rated low, moderate, or high.
- This approach seeks to ensure that an activity with low materiality but high net risk does not skew the overall rating.
- *Greater attention will typically be focused on material activities rated high net risk.*

Thank You